such a judgment amount would threaten the firm's viability.[145]

As discussed above, the Committee believes that the loss of one of the larger auditing firms would likely have a significant negative impact on the capital markets. Of greatest concern is the potential disruption to capital markets that the failure of a large auditing firm would cause, due to the lack of sufficient capacity to audit the largest public companies and the possible inability of public companies to obtain timely audits.[146] The Committee believes these concerns must be balanced against the importance of auditing firms and their partners, as private, for-profit businesses, being exposed to the consequences of failure, including both the legal consequences and economic consequences.

In consideration of these competing concerns, the Committee makes the following recommendations:

(a) As part of its current oversight over registered auditing firms, the PCAOB should monitor potential sources of catastrophic risk which would threaten audit quality.

The PCAOB's mission is to oversee auditing firms conducting audits of public companies. Its audit quality-focused mission is intertwined with issues of catastrophic risk, as most often risks to firms' survival historically have been largely the result of significant audit quality failures or serious compliance issues in the non-audit services aspect of their business.

Sarbanes-Oxley provides the PCAOB with registration, reporting, inspection, standard-setting, and enforcement authority over public company auditing firms.[147] Under its inspection authority, the PCAOB inspects audit engagements, evaluates quality control systems, and tests as necessary audit, supervisory, and quality control procedures. For example, in its inspection of an auditing firm's quality control systems, the PCAOB reviews the firm's policies and procedures related to partner evaluation, partner compensation, new partner nominations and admissions, assignment of responsibilities, disciplinary actions, and partner terminations; compliance with independence requirements; client acceptance and retention policies and procedures; compliance with professional requirements regarding consultations on accounting, auditing, and SEC matters; internal inspection program; processes for establishing and communicating audit policies, procedures, and methodologies; processes related to review of a firm's foreign affiliate's audit performance; and tone at the top.[148]

The PCAOB also has authority to require registered auditing firms to provide annual and periodic reports. In May 2006, the PCAOB issued *Proposed Rules on Periodic Reporting by Registered Public Accounting Firms* requiring annual and periodic reporting.[149] The PCAOB has not yet finalized this proposal.

The Committee therefore recommends that the PCAOB, in furtherance of its objective to enhance audit quality and effectiveness, exercise its authority to monitor meaningful sources of catastrophic risk that potentially impact audit quality through its programs, including inspections, registration and reporting, or other programs, as appropriate. The objective of PCAOB monitoring would be to alert the PCAOB to situations in which auditing firm conduct is resulting in increased catastrophic risk which is impairing or threatens to impair audit quality.

(b) Establish a mechanism to assist in the preservation and rehabilitation of a troubled larger auditing firm. A first step would encourage larger auditing firms to adopt voluntarily a contingent streamlined internal governance mechanism that could be triggered in the event of threatening circumstances. If the governance mechanism failed to stabilize the firm, a second step would permit the SEC to appoint a court-approved trustee to seek to preserve and rehabilitate the firm by addressing the threatening situation, including through a reorganization, or if such a step were unsuccessful, to pursue an orderly transition.

The Committee considered testimony regarding the importance of the viability of the larger auditing firms and the negative consequences of the loss of one of these firms on the capital markets. The Committee also considered commentary regarding issues auditing firms faced in addressing circumstances that threatened their viability, including, in particular, problems arising from the need to work with regulators and law enforcement agencies.[150] Several witnesses suggested the development of a mechanism to allow auditing firms facing threatening circumstances to emerge from those situations.[151] Committee member and former Federal Reserve Chairman Paul Volcker opined that, ''[I]f we had [such an] arrangement at the time Andersen went down, we would have saved it.'' [152] The Committee recommends the following two-step mechanism described below.

First Step—Internal Governance Mechanism

The Committee notes that auditing firms operate as partnerships, generally led by a centralized management team, with a supervisory board of partners overseeing management's strategy and performance.[153] In the event of threatening circumstances at a larger auditing firm, the Committee believes that a lack of effective centralized governance mechanisms may delay crucial decision making, impede difficult decisions that could sustain the firm and its human assets, and lessen the firm's ability to communicate with maximum responsiveness and effectiveness with private, regulatory and judicial bodies.

The Committee therefore recommends that larger auditing firms (those with 100 or more public company audit clients that the PCAOB inspects annually) establish in their partnership agreements a contingent internal governance mechanism, involving the creation of an Executive Committee (made up of partners or outsiders) with centralized firm management powers to address threatening circumstances. The centralized governance mechanism would have full authority to negotiate with regulators, creditors, and others, and it would seek to hold the firm's organization intact, including preserving the firm's reputation, until the mitigation of the threat, or, failing that, the implementation of

[145] *Jury Awards Rise Against BDO Seidman,* Assoc. Press, Aug. 15, 2007.

[146] See 2008 GAO Report 35, 36 (observing that further audit market concentration would ''leave large companies with potentially only one or two choices for a new auditor'' and that ''the market disruption caused by a firm failure or exit from the market could affect companies' abilities to obtain timely audits of their financial statements, reducing the audited financial information available to investors''). See also London Economics, Final Report to EC–DG Internal Market and Services, Study on the Economic Impact of Auditors' Liability Regimes 24 (Sept. 2006) (''The adjustment to a situation in which one of the Big-4 networks fails is unlikely to be smooth. But the long run consequences are likely to be limited provided the overall statutory audit capacity does not fall significantly. Among the various economic sectors, financial institutions may find such a situation particularly difficult as their statutory audits are viewed as more risky and * * * two Big-4 firms dominate the market for statutory audits of financial institutions. The situation is likely to be much direr if a second Big-4 network fails shortly after the first one. Investors' confidence will be in all likelihood seriously affected and the adjustment to the new situation is likely to be difficult.'').

[147] Sarbanes-Oxley Act of 2002, 15 U.S.C. 7211–7219.

[148] See, e.g., PCAOB, Observations on the Initial Implementation of the Process for Addressing Quality Control Criticisms within 12 Months after an Inspection Report, PCAOB Release No. 104–2006–078 (Mar. 21, 2006). See also the PCAOB's completed inspection reports at *http://www.pcaobus.org/Inspections/Public_Reports/index.aspx#k*.

[149] PCAOB Release No. 2006–004 (May 23, 2006).

[150] See, e.g., Securities and Exchange Commission, Temporary Final Rule and Final Rule: Requirements for Arthur Andersen LLP Auditing Clients, SEC Release No. 33–8070 (Mar. 18, 2002); Securities and Exchange Commission, Press Rel. No. 2002–39 and Order Rel. No. 33–8070 (March 18, 2002) (indictment of Arthur Andersen); SEC Staff Accounting Bulletin No. 90 (Feb. 7, 1991) (bankruptcy of Laventhol & Horwath).

[151] Record of Proceedings (Dec. 3, 2007) (Written Submission of James R. Doty, Partner, Baker Botts L.L.P., 11–13), *available at http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Doty120307.pdf* (suggesting that the Bankruptcy Code be amended to prevent creditors whose claims relate to violations of professional standards from opposing reorganization under a court-approved plan; an automatic stay against partners facilitating partner retention; expanding the SEC's emergency powers to enable the SEC to act by summary order to address the registered firm's ability to continue to provide audit services; and encouraging the SEC or PCAOB to discourage ''client poaching'' by requiring public companies to show that switching auditors was not related to mega-judgments against audit affiliates in other jurisdictions). See also Record of Proceedings (Dec. 3, 2007) (Written Submission of Peter S. Christie, Principal, Friemann Christie, LLC, 6), *available at http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Christie120307.pdf* (''If it remains possible that a firm can fail for reasons other than liability claims it may be attention needs to be given to devices that will permit a firm to re-emerge.'').

[152] Record of Proceedings (Mar. 13, 2008) (Oral Remarks of Committee Member Paul Volcker, 317), *available at http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-03–13–08.pdf.*

[153] Center for Audit Quality, Report of the Major Public Company Audit Firms to the Department of the Treasury Advisory Committee on the Auditing Profession 13 (Jan. 23, 2008).